# Securities Regulation Daily Wrap Up, TOP STORY—Senate panel considers conflicts of interest in high frequency trading, explores Reg. NMS changes, (Jun. 17, 2014)

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As the SEC weighs a complete overhaul of market structure, the Senate Subcommittee on Investigations explored the conflicts of interest in high frequency trading and the efficacy of amending Regulation NMS.

In his opening statement Subcommittee Chair Carl Levin (D-Mich.) expressed concern with conflicts of interest inherent in high frequency trading, adding that it is the duty of policymakers and regulators to properly monitor the financial markets. While the U.S. generally embraces technology, he noted, there are concerns when technology undermines the basic principles of securities regulation. The ultimate goal of policy and regulation is to protect investors and foster free markets.

**Conflicts of interest.** Conflicts of interest damage investors and markets, said the Senator, by depriving investors of the certainty that brokers are placing the interests of their clients first and by feeding a belief that the markets are unfair. Conflicts of interest can arise when a retail broker picks a wholesale broker to execute a trade or when a broker chooses a trading venue to execute a trade. At both decision points, he noted, the current market structure gives brokers an incentive to place their own interests ahead of the interest of their clients.

The first conflict of interest is payments for order flow. When a retail investor places a stock order with a broker, the broker often does not execute that order directly on an exchange. Rather, the broker may direct the order to a wholesale broker in exchange for payment, and the wholesale broker will then typically execute the order using its own inventory.

The second conflict of interest relates to rebates paid to brokers by stock exchanges and other trading venues. There are currently eleven public stock exchanges plus over 200 alternative trading systems, including a large number of dark pools. These trading venues offer various rebate structures in order to attract brokers, and orders, to their platforms.

Trading venues pay brokers to place some kinds of orders, earning brokers what are known as “maker” rebates. Other kinds of orders incur a charge from the exchange, known as a “taker” fee. Some brokers place orders that automatically prevent a trade from completing if the trade would cost the broker a “taker” fee.

The trading venue offering the biggest “maker” rebate or smallest “taker” fee may not necessarily offer best execution for a trade, said Senator Levin.

The hearing examined academic research that suggests that some retail brokers may routinely send some kinds of orders to venues offering the most profitable arrangement for the broker. This research suggests that such a strategy comes at the expense of best execution for customers.

Senator John McCain (R-Ariz.), the Subcommittee’s Ranking Member, said that high frequency trading may be hurting confidence in the financial markets for retail investors. The price mandate of SEC Regulation NMS is being taken advantage of by high frequency trading firms. Senator McCain urged the amending of Regulation NMS as a first step in cleaning up the worst of high frequency trading abuses

**NYSE testimony.** Thomas Farley, President of the New York Stock Exchange, testified that the U.S. equities market is highly fragmented, making it overly complex and opaque. The regulations and structures in place today incentivize participants to make it more complex and more opaque, he averred. Numerous surveys and recent history have shown that this structure does not contribute to investor confidence or high systems reliability.

As the dominant rule setting the boundaries of equity market structure, SEC Regulation NMS set out to accomplish several objectives. One was to increase competition among markets and to increase competition among orders. While the rule did an excellent job of increasing competition among markets, the NYSE believes

competition of orders has been severely damaged, particularly in recent years, due to the record level of off-exchange trading and increased levels of order fragmentation. The NYSE chief urged the SEC to consider revisions to Regulation NMS that would better enable it to meet stated goals by removing some of the conflicts outlined by Senators Levin and McCain and thereby restore confidence in the markets.

He announced that the NYSE is taking steps to reduce the level of complexity and fragmentation of the stock market. To accomplish this goal, there are several unilateral steps that the NYSE is committing to take, such as self-imposing a six-month moratorium on any new, or novel, order types that further segment the market. Also, at an industry level, the NYSE urges the elimination of maker-taker pricing and the use of rebates. Broad adoption of this policy would reduce the conflicts inherent in such pricing schema and further reduce complexity through fewer order types and fewer venues. In conjunction with the elimination of maker-taker and rebates, regulations should require that deference be given to displayed quotes.

**BATS testimony.** Joe Ratterman, CEO of BATS Global Markets, also called for the revision of Regulation NMS. All exchanges are given a significant competitive advantage regardless of their size by virtue of the order protection rule under Regulation NMS. While this was necessary in an era where legacy exchanges routinely ignored their competitors, he noted, current practices have reduced the need for regulatory protections of smaller venues.

Thus, the BATS CEO called for the SEC to revise Regulation NMS so that, until an exchange achieves greater than a de minimis level of market share, for example 1 percent, in any rolling three-month period, they should no longer be protected under the order protection rule and they should not share in or receive any NMS plan market data revenue. In his view, the combination of these two provisions would reduce client costs in connecting to small exchanges, giving them the flexibility to route around them should they so choose, while still protecting displayed limit orders on all venues of meaningful size; and take away market data revenue that may be the basis for the continued operation of marginal venues.

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